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In the Supreme Court of the United States

OCTOBER TERM, 1981

VICTOR P. DIEDRICH AND
FRANCES T. DIEDRICH, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
EXECUTOR OF THE ESTATE OF FRANCES D. GRANT,
DECEASED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether petitioners' transfers of appreciated property to various donees, on the condition that the donees pay the gift tax liability imposed upon petitioners, resulted in taxable gain to petitioners to the extent that the gift taxes paid by the donees exceeded petitioners' bases in the property.

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OPINIONS BELOW

The memorandum findings of fact and opinion in *Diedrich* v. *Commissioner* (Pet. App. A17-A22) and the memorandum opinion in *Grant* v. *Commissioner* (Pet. App. A12-A16) are not officially reported. The opinion of the court of appeals (Pet. App. A1-A11) is reported at 643 F.2d 499.

JURISDICTION

The judgments of the court of appeals were entered on March 4, 1981 (Pet. App. A23-A24). The orders denying petitions for rehearing and suggestions for rehearings en banc were entered on March 27, 1981 (Pet. App.

A25-A26). The petitions for a writ of certiorari were filed on June 25, 1981, and were granted on October 5, 1981. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant provisions of Sections 61, 451, 644, 671, 1001, 1015, 2501 and 2502 of the Internal Revenue Code of 1954 (26 U.S.C. (1970 ed.)) are set forth at Appendix, *infra*, 1a-8a. The relevant provisions of §§ 1.1001-1(e) and 1.1015-4 of the Treasury Regulations on Income Tax (26 C.F.R.), are set forth at Appendix, *infra*, 8a-9a.

STATEMENT

A. The Facts of These Cases

1. *Diedrich.* On April 1, 1972, petitioner Victor P. Diedrich made a gift of 51,073 shares of voting and nonvoting common stock of Owatonna Manufacturing Company, Inc. (OMC), to or for the benefit of his three adult children, Eugene F. Diedrich, JoAnn D. Petkus, and Madelyn D. Smith. On the same day, petitioner Frances T. Diedrich made the following gifts: 17,085 shares of OMC voting and nonvoting common stock to her son Eugene; a total of 17,024 shares of nonvoting common stock to irrevocable trusts for the benefit of her two daughters JoAnn D. Petkus and Madelyn D. Smith. At the time the gifts were made, Eugene, acting for himself and as the trustee of the Petkus and Smith Trusts, signed three agreements on behalf of each of the donees, promising that as a condition of receiving the gifts, each donee would pay its share of the federal and state gift taxes for which petitioners were liable (Pet. App. A17-A18).

For federal gift tax purposes, petitioners agreed to treat their gifts as if made one-half by each and so reported the gifts for the second quarter of 1972. Petitioners valued the OMC stock that they transferred to Eugene and to the Petkus and Smith Trusts at $7.80 per share. Accordingly, the gross amount of the gift of 51,073

shares of OMC stock reported on the return was $398,369. The donees paid the resulting federal gift tax liability of $62,992 in 1972 (Pet. App. A18).[1]

In order to satisfy petitioners' federal gift tax liability which they promised to discharge, Eugene, acting in his individual capacity and as trustee of the Petkus and Smith Trusts, borrowed $62,992 from OMC. The total sum of the loan was advanced in three separate checks, each payable to the respective borrower. On or before August 15, 1972, Eugene paid the federal gift tax individually and as trustee of the trusts, by endorsing these checks to the order of the Internal Revenue Service (Pet. App. A19).

The Petkus and Smith Trusts each sold 2,728 shares of OMC stock to OMC in December 1972 at $7.80 per share, in order to pay the principal and interest on their loans from OMC. Eugene paid the principal and interest on the loans from OMC with his personal funds. On or before April 15, 1973, the trusts sold additional shares of OMC stock at $7.80 per share to pay their respective portions of petitioners' Minnesota gift tax liability. Eugene again used his personal funds to pay his portion of petitioners' state gift tax (Pet. App. A19).[2]

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[1] The donees also paid Minnesota gift taxes of $18,508 in 1973 (Pet. App. A18-A19).

[2] On audit of petitioners' federal gift tax returns in 1974, the Commissioner of Internal Revenue determined that the value of the OMC stock transferred to the donees was $13 per share at the time of the gift, and not the $7.80 per share figure reported. Accordingly, the Service determined that the value of the 51,073 shares was $663,949, and additional federal and Minnesota gift taxes of $64,213 were paid by the donees in 1975 (Pet. App. A19).

After the audit, which resulted in an increase in the gift tax liabilities of petitioners, OMC agreed to pay the Petkus and Smith Trusts additional consideration for the purchase of their stock in December 1972. OMC increased its purchase price from $7.80 to $13 per share to conform to the revised value and also agreed to pay interest to the trusts from the date of the sale to the date of payment of such additional consideration. Each trust used the additional amounts paid by OMC to pay its share of the federal and Minnesota

Petitioners had a basis of $1 per share in the OMC stock that they transferred to Eugene and the trusts for the benefit of their daughters. On their 1972 federal income tax return, petitioners did not report any income as a result of their transfers of the stock on the condition that the donees pay the gift taxes for which petitioners were liable. On audit, the Commissioner of Internal Revenue determined that petitioners received taxable gain to the extent that their gift tax liabilities discharged by the donees exceeded their bases in the transferred stock. A deficiency in petitioners' taxable income of $5,959 was accordingly determined (Pet. App. A3, A20-A21).[3]

2. *United Missouri Bank.* Petitioner is the executor of the Estate of Frances D. Grant. In August 1970, when she was more than 90 years of age, the decedent[4] made a gift of 50,000 Class "A" Voting Trust Certificates, representing common stock of BMA Corporation, to her son William D. Grant. Petitioner's basis in the certificates was $4,857. The gift was made on the condition that

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gift tax deficiencies assessed against petitioners. Eugene paid his portion of the additional taxes from his personal funds (Pet. App. A19-A20).

If the judgment below is affirmed, petitioners agree that they will be required to recognize additional gain in 1975 to take these additional amounts of gift tax into account, and that they will be further required to recognize additional gain in 1973, representing the donees' payment of the Minnesota gift taxes.

[3] The deficiency of $5,959 was computed as follows (Pet. App. A3):

Gift tax paid in 1972	$62,992
Less: Bases in stock transferred	51,073
Long term capital gain	11,919
50% deduction for long-term capital gain	5,959
Increase in taxable income	$ 5,959

[4] When the context so indicates, the term "petitioner" refers to the decedent Frances D. Grant, rather than her executor, United Missouri Bank.

William pay the gift taxes for which petitioner was liable. On or about April 15, 1971, petitioner reported the gift on her gift tax return, which showed gift taxes of $106,334.32 owing as a result of the gift (Pet. App. A14).

In January 1971, petitioner gave her son an additional 40,000 voting trust certificates in BMA Corporation, on the same condition that he pay the gift taxes shown to be due on her gift tax return. Petitioner's basis in these certificates was $3,885.60. The gift taxes due as a result of the second gift were $126,295.77 (Pet. App. A14-A15).[5]

On audit of petitioner's income tax returns for 1970 and 1971, the Commissioner of Internal Revenue determined that petitioner realized long-term capital gain from the transfer of the voting trust certificates to her son William, in the amount that her gift tax obligation discharged by her son exceeded her basis in the property. The Commissioner accordingly determined to increase petitioner's taxable income by $111,943.75 (Pet. App. A3, A14-A15).[6]

B. The Proceedings Below

Petitioners Diedrich and Grant thereafter sought redetermination in the Tax Court of the income tax deficiencies determined as a result of their transfers of

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[5] Although the Tax Court did not determine the fair market value of the certificates at the time of the gift, the substantial gift tax paid ($232,630.09) indicates that the value of the certificates approximated $1 million. See Section 2502 of the Internal Revenue Code of 1954.

[6] The increase in petitioner's taxable income was computed as follows (Pet. App. A3):

Gift tax paid in 1971	$232,630.09
Less basis in certificates transferred	8,742.60
Long-term capital gain	223,887.49
50% deduction for long-term capital gain	111,943.75
Increase in taxable income	$111,943.75

appreciated property on the condition that the donees pay the gift taxes arising as a result of the transfers (J.A. 3-14, 25-34). Adhering to its prior line of decisions beginning with *Turner* v. *Commissioner*, 49 T.C. 356 (1968), aff'd per curiam, 410 F.2d 752 (6th Cir. 1969),[7] the Tax Court upheld petitioners' position that they merely made a net gift[8] of the difference between the fair market value of the transferred property and the gift tax paid by the donees. In those prior cases, the Tax Court had ruled that the donor does not realize taxable income as a result of the transfer in such a situation (Pet. App. A12-A22).

The court of appeals reversed (Pet. App. A1-A11).[9] It "agree[d] with the Commissioner that *Turner* and its progeny were incorrectly decided" (Pet. App. A6). It accordingly ruled that "to the extent the gift taxes paid by donees exceeded donor's adjusted bases in the

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[7] See *Estate of Davis* v. *Commissioner*, 30 T.C.M. (CCH) 1363 (1971), aff'd per curiam, 469 F.2d 694 (5th Cir. 1972); *Hirst* v. *Commissioner*, 63 T.C. 307 (1974), aff'd, 572 F.2d 427 (4th Cir. 1978) (en banc); *Estate of Henry* v. *Commissioner*, 69 T.C. 665 (1978), appeal pending, No. 78-1340 (6th Cir.). See also *Bradford* v. *Commissioner*, 70 T.C. 584 (1978), appeal pending, No. 79-1094 (6th Cir.); *Krause* v. *Commissioner*, 56 T.C. 1242 (1971); *Estate of Weeden* v. *Commissioner*, 39 T.C.M. (CCH) 699 (1979), appeal pending, No. 80-7127 (9th Cir.); *Benson* v. *Commissioner*, 37 T.C.M. (CCH) 989 (1978), appeal pending, No. 79-1032 (6th Cir.). But cf. *Owen* v. *Commissioner*, 652 F.2d 1271 (6th Cir. 1981), decision vacated, Sept. 11, 1981.

[8] A "net gift" is a shorthand description of a gift made on the condition that the donee pay the gift tax liability of the donor as a result of the transfer. Because this payment is treated as consideration received by the donor, only the excess, or "net," transfer is the amount of the gift. This offset will correspondingly reduce the gift tax due. Accordingly, the tax must be computed by using an algebraic formula. See Rev. Rul. 75-72, 1975-1 Cum. Bull. 310. However, Rev. Rul. 75-72, *supra*, "is concerned only with the gift tax consequences * * * [of a net gift transfer] and not with the income tax consequences thereof" (1975-1 Cum. Bull. at 313).

[9] On appeal, the two cases were consolidated for argument and decision.

property transferred, the donors realized taxable income" (Pet. App. A11). In so holding, the court observed that "when the donor's gift tax liabilities were discharged by the donees, the benefit conferred resulted in taxable income" (Pet. App. A10). As the court saw the matter, the Tax Court's characterization of the transaction as a "net gift" does not alter the essential economic fact that the donor is actually transferring the entire property and receiving something in return and that the amount received in return is a benefit that constitutes taxable income to the extent it exceeds the donor's basis in the property. The court therefore cited with approval the dissenting opinion in *Hirst* v. *Commissioner*, 572 F.2d 427 (4th Cir. 1978) (en banc), that "[t]he effect of what was done * * * is the same as though [the donees] had paid the money directly to taxpayer[s] and [they] had used it to discharge [their] gift tax liabilities" (*id.* at 438).

The court found further support for its ruling in *Johnson* v. *Commissioner*, 495 F.2d 1079 (6th Cir.), cert. denied, 419 U.S. 1040 (1974), and *Estate of Levine* v. *Commissioner*, 634 F.2d 12 (2d Cir. 1980). Those decisions held that donors of property encumbered by nonrecourse indebtedness received taxable gain to the extent that the indebtedness exceeded their bases in the property. As the court below stated, "[i]t makes no difference whether he [the donor] receives the benefit in the form of relief of encumbrance, or in the form of relief of tax liability; in either case, the determinative factor is the receipt of the benefit" (Pet. App. A10).

SUMMARY OF ARGUMENT

1. Section 61(a) of the Internal Revenue Code of 1954 (26 U.S.C.) provides that gross income means all income from whatever source derived. Section 1001(a) of the Code provides in particular that the gain from a sale or other disposition of property is the excess of the amount realized therefrom over the transferor's adjusted basis in the property. The amount realized is defined

in Section 1001(b) as the sum of money received plus the fair market value of any other property received.

It is well established that the amount realized under Section 1001 does not mean that the taxpayer must receive cash (or property) in hand. Rather, the concept of amount realized encompasses a measurable economic benefit in any of many forms, including a discharge of personal liability. Thus, in *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716 (1929), this Court held that payment of a taxpayer's federal income tax liability by another person is tantamount to actual payment of that amount to the taxpayer and use by him of that money to pay his taxes. Similarly, the discharge of indebtedness on the transfer of property constitutes the receipt of income for purposes of Section 61(a). *Crane* v. *Commissioner*, 331 U.S. 1, 13-14 (1947).

Old Colony Trust and *Crane* control this case and require affirmance of the judgment below. In accordance with these principles, the court of appeals correctly held that petitioners were taxable on their net gift transfers to the extent that the gift taxes paid exceeded their adjusted bases in the property transferred. In both of these cases, petitioners made a gift of low basis, highly appreciated securities to a member of their family. As a condition of the gift, the donees agreed to pay the donors' federal and state gift taxes incurred as a result of the gift. The gift taxes paid by the donees in each instance exceeded petitioners' bases in the securities transferred (Pet. App. A3). By making the gifts conditional on the donees' payment of the applicable gift taxes, petitioners received a real and substantial economic benefit, because the donees' payment discharged petitioners from their primary liability for the payment of gift taxes on the transfers. See Sections 2502(d) and 6324(b) of the Code. As the court below observed (Pet. App. A10), the making of a net gift is tantamount to the donee's having paid money directly to the donor for the latter's use in paying his gift tax liability. Since the

donor would clearly be liable for tax in that case, assuming the amount realized exceeded his basis (cf. Treasury Regulations on Income Tax, § 1.1001-1(c) (26 C.F.R.)), there is no reason for excusing him from income tax on such a transfer merely because a different route leading to the same destination is followed. As this Court admonished in *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613 (1938), "[a] given result at the end of a straight path is not made a different result because reached by following a devious path."

Thus, in *Johnson* v. *Commissioner*, 495 F.2d 1079 (6th Cir), cert. denied, 419 U.S. 1040 (1974), the court imposed an income tax upon the donor of low basis, highly appreciated stock where, immediately prior to the gift, the donor had pledged the stock as collateral for a loan, the proceeds of which were used in large part to satisfy the donor's gift tax liability on the transfer. Describing the interrelated series of transactions there as equivalent to the donee's payment of the donor's gift tax liability, the court of appeals stated that "[t]he payment of a donor's gift tax liability by the donee constitutes income to the donor" (495 F.2d at 1083). The Second Circuit reached a similar conclusion in *Estate of Levine* v. *Commissioner*, 634 F.2d 12 (2d Cir. 1980), where the donor of property encumbered by nonrecourse mortgages in excess of his adjusted basis was held taxable on that excess. Expressing agreement with the decision in *Johnson*, the court in *Levine* stated that "the assumption of another's legal obligation or debt is considered income" (634 F.2d at 16).

2. *Turner* v. *Commissioner*, 49 T.C. 356 (1968), aff'd per curiam, 410 F.2d 752 (6th Cir. 1969), and *Hirst* v. *Commissioner*, 572 F.2d 427 (4th Cir. 1978) (en banc), upon which petitioners rely, were incorrectly decided. The incidence of taxation does not turn on the subjective intent of the donor, as those courts held. Rather, it flows from the economic substance of the transaction. In these so-called net gift transfers, where the donor transfers low basis appreciated property on the condition that the

donee pay the gift tax, the donor realizes a definite amount upon the donee's discharge of the donor's primary liability for payment of the gift tax. If the donor's gift tax liability exceeds his basis in the property transferred, the donor has taxable gain despite the fact that he may not have "intended" to effect a sale or other taxable disposition of the gift property. As this Court observed in *Commissioner* v. *Duberstein*, 363 U.S. 278, 286 (1960), "It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter."

3. A decision in favor of the Commissioner's position should be fully applicable to petitioners in these cases. Petitioners and the amici claim that any decision by this Court in favor of the Commissioner should be prospective only on grounds of *stare decisis* and their purported reliance on the Sixth Circuit's decision in *Turner*. But, as the court of appeals correctly stated, a taxpayer residing in one circuit may not avoid a tax otherwise due by claiming reliance upon a decision of another court of appeals. Indeed, even reliance upon a decision of the court of appeals in the taxpayer's home circuit will not relieve him from taxation if the rule announced there is ultimately rejected by this Court. See *C. Blake McDowell, Inc.* v. *Commissioner*, 652 F.2d 606 (6th Cir. 1980). Thus, in *United States* v. *Estate of Donnelly*, 397 U.S. 286 (1970), this Court's decision upholding the validity of a federal tax lien was applied even though the prevailing interpretation of the tax lien statute at issue in the taxpayer's home circuit would have invalidated the lien.

In making their net gift transfers, petitioners therefore simply ran the risk that the rule of law announced in *Turner* would not ultimately survive. As this Court held in *Chevron Oil Co.* v. *Huson*, 404 U.S. 97 (1971), judicial decisions should be applied to all pending cases unless a "new principle of law" established would be aided by prospective application only and nonretroactive treatment would avoid "substantial inequitable results." Given the

Commissioner's consistent position over the past 25 years as to the income tax consequences of net gift transfers, taxing petitioners on the gain they realized in these transactions in 1972 does not produce "substantial inequitable results."

ARGUMENT

A DONOR'S TRANSFER OF PROPERTY SUBJECT TO THE CONDITION THAT THE DONEE PAY THE DONOR'S GIFT TAX LIABILITY RESULTS IN TAXABLE GAIN TO THE DONOR TO THE EXTENT THAT THE GIFT TAXES PAID BY THE DONEE EXCEED THE DONOR'S BASIS IN THE PROPERTY

A. A person realizes taxable gain when another party pays his indebtedness or discharges his liability

1. This case presents an important question on which the courts of appeals have divided concerning the income tax consequences to the donor upon the gift of appreciated property, where the gift is made on the condition that the donee pay the donor's gift tax liability imposed upon the transfer, and the gift taxes exceed the donor's basis in the property. Unlike the ordinary gift, the type of transaction at issue here involves consideration flowing in both directions between the donor and donee. First, the appreciated property is transferred from donor to donee; second, in exchange for, and on condition of, the gift, the donee pays the donor's gift tax liability that arises as a result of the transfer. It is the latter aspect of the transaction—the donee's payment of the gift tax liability—that is the focus of the Commissioner of Internal Revenue's determination and the court of appeals' decision that the donor has realized taxable gain to the extent that the gift tax exceeds the basis in the property.

An example will help to illustrate the problem posed by the transactions in this case. Suppose A has stock worth $1 million with a basis of $1,000. He transfers it to his son B on the condition that B pay the gift tax liability of $200,000 that is imposed upon A as a conse-

quence of the transfer. In accordance with his promise, B pays $200,000 to the Internal Revenue Service that would otherwise be payable by A. Properly analyzed, A has "received" $200,000 from B's discharge of his gift tax liability and that discharge was made in exchange for the transfer. There can be no doubt that the gift tax obligation belongs to the donor A. Section 2502(d) of the Internal Revenue Code provides that "The tax imposed by section 2501 [the gift tax] shall be paid by the donor." Thus, if B undertakes to discharge A's gift tax liability, B's payment of A's obligation is income to A.

The fact that A never received the money in hand is of no consequence for purposes of the tax law. A is deemed to have received the $200,000 because that amount was used to discharge his indebtedness, and such a measurable economic benefit constitutes gross income. In this respect, the transaction is similar to an employer's paying his employee's grocery or utility bills. Such amounts are taxable compensation despite the fact that the money goes directly from the employer to the grocer or utility company. It is the discharge of the employee's liability that constitutes gross income. As this Court held more than 50 years ago in *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729 (1929), an employer's payment of his employee's income tax represents gross income to the employee. "The form of the payment is expressly declared to make no difference. * * * It is therefore immaterial that the taxes were directly paid over to the Government. The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed" (*ibid.*). Indeed, if the rule were otherwise, different tax consequences would turn on the empty formalism of whether B transferred the money to A for payment to the tax collector, or whether B paid it directly to the tax collector. Accord: *Douglas* v. *Willcuts*, 296 U.S. 1 (1935); *Wall* v. *United States*, 164 F.2d 462, 464 (4th Cir. 1947). See also Section 61(a)(12) of the Code

(gross income includes "Income from discharge of indebtedness").

Returning to our example, it is therefore clear that A, who stands in the place of petitioners in these cases, is properly chargeable with income equal to the amount of his gift tax indebtedness discharged by B. But what is the character of the income that A has received? Suppose, as in *Old Colony Trust Co.*, A's employer, or someone other than the donee B, has undertaken to pay A's gift tax obligation. Putting aside the possibility that the payments were a gift to A, there could be little doubt in such circumstances that A would be deemed to have received $200,000 in additional income taxable at ordinary rates. If the person discharging A's gift tax liability were A's employer, that additional ordinary income would have doubtless fit within the statutory rubric "Compensation for services, including fees, commissions, and similar items" (Section 61(a)(1)). Here, however, B's discharge of A's gift tax liability is an integral component of the transaction in which A has transferred the appreciated stock to B. Since A has made the gift on the condition that B pay his gift taxes, B's discharge of A's obligation is, in contractual and economic terms, consideration in exchange for the transfer.

When these factors are put in statutory terms, it becomes clear that the $200,000 paid by B to the tax collector on behalf of A is an "amount realized" by A upon his transfer of the stock to B. Section 61(a) of the Code provides that gross income "means all income from whatever source derived * * *," including "Gains derived from dealings in property * * *" (Section 61(a)(3)). Section 1001(a) provides that "[t]he gain from the sale or other disposition of property shall be the excess of the amount realized * * * over the adjusted basis * * * [of the property]." The term "amount realized" is defined by Section 1001(b) as "the sum of any money received plus the fair market value of the property (other than money) received."

Here, A has received $200,000 upon the disposition of stock with a basis of $1,000. Hence, the proper computation of his taxable gain is $200,000—the amount realized—less his $1,000 basis, or $199,000. Since the transaction involved A's transfer of the stock in "exchange" for B's payment of A's gift tax liability, A's taxable gain is subject to the preferential capital gains rates available for sales and exchanges of capital assets. See Sections 1201, 1221, 1222 of the Code.[10]

Finally, petitioners claim (Br. 17, 20-25) that they did not realize taxable gain as a result of their net gift transfers because the transfers did not constitute a "sale or exchange." But Section 1001(a) of the Code provides for the taxation of "gain from the sale *or other disposition* of property" (emphasis supplied). It is settled that gifts constitute "dispositions" for tax purposes, and thus may result in taxable gain. See, *e.g.*, *Estate of Levine* v. *Commissioner*, 634 F.2d 12 (2d Cir. 1980), aff'g 72 T.C. 780 (1979); *Guest* v. *Commissioner*, 77 T.C. 9 (1981). In the case of a simple (rather than net) gift, no amount is realized because the donor receives nothing. But where, as here, the donor realizes, by virtue of the discharge of his resulting gift tax liability, an amount in excess of his basis of the property transferred, taxable gain is the result. Indeed, the logical consequence of petitioners' argument that there was no sale or other disposition would require taxation of the full amount of the payment as ordinary income from the discharge of indebtedness, without any offset for basis. See Section 61(a)(12) of the Code. Compare Section 108 of the Code (exception for insolvent taxpayers).

2. The decisions of this Court support the foregoing analysis of the transaction at issue in this case. Just as *Old Colony Trust Co.* established that an employer's pay-

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[10] In economic terms, the example is equivalent to A's sale of the stock to B for $200,000. Since the stock is worth $1 million, A has made a gift to B of $800,000. And in these circumstances, A would be required to recognize taxable gain of $199,000—$200,000 less his basis of $1,000.

ment of the tax liability of his employee gave rise to taxable income to the employee, there is analogous precedent holding that the discharge of any type of indebtedness in connection with the disposition of property constitutes taxable income to the party who is relieved of indebtedness. As the Court observed in *Helvering* v. *Bruun*, 309 U.S. 461, 469 (1940), "[T]he realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction."

Indeed, the Court subsequently made clear in *Crane* v. *Commissioner*, 331 U.S. 1 (1947), that the discharge of indebtedness rule was fully applicable with respect to a mortgage obligation. There, the taxpayer sold property subject to an outstanding nonrecourse mortgage, for cash plus the buyer's assumption of the mortgage. The Court held that: (1) the face amount of the mortgage was properly includable in the taxpayer's basis in the property; and (2) the amount realized upon the sale included not only the cash tendered by the buyer but also the face amount of the nonrecourse mortgage assumed by the buyer.

It is the second aspect of the *Crane* holding that is instructive in resolving the issue presented in the instant cases. In *Crane*, the buyer's assumption of the mortgage constituted a discharge of the seller's indebtedness that had to be taken into account in computing the "amount realized" by the taxpayer upon the sale. For a solvent taxpayer like Mrs. Crane or petitioners in these cases, a discharge of indebtedness represents a measurable economic benefit that is includable in gross income. As the Court explained, "We are * * * concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real

and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another" (331 U.S. at 14).[11]

3. In our view, the principles established by this Court in *Old Colony Trust Co.* and *Crane* control this case and require affirmance of the judgment below. There, as here, the taxpayer's indebtedness or liability was paid by another party. As was the case in *Old Colony Trust Co.*, petitioners' liability was for taxes imposed upon them as a personal obligation.[12] And, as in *Crane*, the obligation was discharged in consideration for the transfer of property. *Old Colony Trust Co.* teaches that the payment of the tax liability of another constitutes taxable income to the relieved taxpayer. The refinement

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[11] The lower courts have applied the *Crane* principle in a variety of factual contexts in which appreciated property is transferred and a mortgage debt secured by the property is discharged. See, *e.g.*, *Simon* v. *Commissioner*, 32 T.C. 935 (1959), aff'd, 285 F.2d 422 (3d Cir. 1960); *First National Industries, Inc.* v. *Commissioner*, 26 T.C.M. (CCH) 608 (1967), aff'd, 404 F.2d 1182 (6th Cir. 1968), cert. denied, 394 U.S. 1014 (1969); *Malone* v. *United States*, 326 F. Supp. 106 (N.D. Miss. 1971), aff'd per curiam, 455 F.2d 502 (5th Cir. 1972).

[12] *Wall* v. *United States*, *supra*, 164 F.2d at 464. Indeed, petitioners appear to agree with this proposition for elsewhere in their brief (at 6, 26) they acknowledge that "[l]egally and economically, the donor has paid the gift taxes." If the gift tax is not paid when due, a ten-year lien is placed on the gift property, and the donee becomes secondarily liable for the tax to the extent of the value of the gift. 26 U.S.C. 6324(b). The donee's liability under that section, however, is secondary and not coextensive with the donor's primary liability. Pursuant to that primary liability, the donor's assets would be subject to collection. efforts by the Service, just as would be the case with respect to any other type of tax. See *Estate of Sheaffer* v. *Commissioner*, 37 T.C. 99, 105 (1961), aff'd, 313 F.2d 738 (8th Cir. 1963), cert. denied, 375 U.S. 818 (1963). It therefore cannot be said that "Congress did not care who paid the gift tax," as one of the amici (Cleaver Br. 18) asserts. Just as the income tax is a liability of the recipient of income, though a transferee may be secondarily liable (see Section 6901 of the Code), here, too, the gift tax is a statutory liability of the donor.

added by *Crane* is that the discharge of indebtedness in connection with the transfer of property is includable in the amount realized by the transferor for purposes of computing taxable gain.

Both the *Old Colony Trust Co.* principle and the *Crane* application of that principle in the context of discharge of indebtedness upon the transfer of property require petitioners to recognize taxable gain to the extent that the gift tax paid by the donees exceeded petitioners' adjusted bases in the property transferred. In *Old Colony Trust Co.*, the Court cited four factors in support of its holding that an employer's payment of his employee's income tax liability constituted income to the employee. These were: (1) the tax liability was imposed upon the employee; (2) the taxes were actually paid by the employer; (3) the employer's payment of his employee's taxes was made pursuant to an express agreement; and (4) the "taxes were paid upon a valuable consideration, namely, the services rendered by the employee and as part of the compensation therefor" (279 U.S. at 729).

The factors that the Court regarded as dispositive in *Old Colony Trust Co.* are likewise present in the instant cases. Here, the gift tax liability was statutorily imposed upon petitioners, the taxes were actually paid by the donees, the payment was made in accordance with an express agreement, and the donees paid the taxes "upon a valuable consideration," namely, the receipt of the gift. Indeed, the fact that petitioners made the gifts in these cases on the condition that the donees pay their gift tax liabilities negates any inference that the donees' payments represented tax-free gifts back to petitioners. The quid pro quo nature of the transaction establishes that the donees' payments of the gift taxes were not transfers motivated by the donees' "detached and disinterested generosity"—the hallmark of a tax-free gift. *Commissioner* v. *Duberstein*, 363 U.S. 278, 285 (1960); *Commissioner* v. *LoBue*, 351 U.S. 243, 246 (1956). Accord: Rev. Rul. 75-72, 1975-1 Cum. Bull. 310, 311.

Contrary to petitioners' (Br. 18, 24, 26) and the amicus Owen's (Br. 8, 13) arguments, this Court's decision in *Old Colony Trust Co.* cannot be confined to the case in which an employer pays the income taxes of his employee as part of the employee's compensation. To be sure, the "valuable consideration" upon which the taxes were paid in *Old Colony Trust Co.* was the services performed by the employee. But nothing in the Court's opinion suggests that compensation for services is the only type of consideration that will support the conclusion that the discharge of another person's tax liability constitutes income to the relieved taxpayer. The critical fact, as the Court pointed out, is that the taxes must be paid in exchange for the taxpayer's performance of some valuable consideration in order to negate any inference that the payment of the tax was a gift (see 279 U.S. at 730). Here, the valuable consideration was petitioners' transfers of the appreciated property. "It is therefore immaterial that the taxes were directly paid over to the Government. The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed" (*id.* at 729).

4. In accordance with these principles, we submit that the court of appeals correctly held that petitioners were taxable on their net gift transfers to the extent that the gift taxes paid exceeded their adjusted bases in the property transferred. By making the gifts conditional upon the donee's payment of the applicable gift taxes, petitioners have received a real and substantial economic benefit because the donees' payments discharged them from their primary liability for the payment of gift taxes on the transfers. See Sections 2502(d) and 6324(b) of the Code. The court below therefore properly observed (Pet. App. A10) that the making of a net gift is tantamount to the donee's having paid money directly to the donor for the latter's use in paying his gift tax liability. There is no reason for excusing the donor from income tax on a net gift transfer merely because a different route leading to the same destination is followed. As

this Court admonished in *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613 (1938), "[a] given result at the end of a straight path is not made a different result because reached by following a devious path."

B. The donees' discharge of petitioners' gift tax liability resulted in petitioners' receipt of a measurable economic benefit that must be included in gross income

1. Once it is recognized that "[t]he form of the payment is expressly declared to make no difference" so that "[i]t is therefore immaterial that the taxes were directly paid over to the Government" (*Old Colony Trust Co.* v. *Commissioner*, *supra*, 279 U.S. at 729), it becomes clear that the critical fact in these cases is petitioners' receipt of a measurable economic benefit in the form of the discharge of their gift tax liabilities. As we have pointed out (*supra*, pages 12-13), the fact that petitioners did not actually receive the money is of no consequence. *Old Colony Trust Co.* teaches that for income tax purposes, the donees' discharge of petitioners' gift tax liability is equivalent to the donees' payment of the amount of the gift tax directly to petitioners themselves, who in turn are deemed to have paid it over to the government.

In these circumstances, the court of appeals correctly concluded that petitioners' net gift transactions are comparable to any transfer of appreciated property where the transferee assumes mortgage encumbrances in excess of the transferor's basis in the property. Put in terms of our previous example (*supra*, page 11-12), suppose A has stock worth $1 million with a basis of $1,000, and the stock is pledged to secure a nonrecourse loan of $200,000. If A thereafter transfers the stock to B, who assumes payment of the loan, A will have taxable gain of $199,000 ($200,000 less $1,000). Under the *Crane* principle, B's assumption of the debt secured by the property is income to A, to the extent that the amount of the debt exceeds the transferor's basis in the property.

In some respects, A's physical receipt of the $200,000 proceeds of the loan to use as he sees fit and B's assump-

tion of it may be viewed as presenting a more graphic case than the facts of the original example for charging A with $199,000 of taxable gain. But the principle applied in both the original example and in the variation on it is precisely the same, *viz.*, the rule of *Old Colony Trust Co.* and *Crane* that the payment or assumption of a debt by another constitutes gross income to the relieved debtor. In the original example, B paid A's $200,000 gift tax obligation; here, B paid A's mortgage indebtedness. In both cases, A has received a measurable economic benefit that must be included in his gross income.

2. Given the close similarity between a net gift and the mortgage assumption variation on the transaction, the court of appeals correctly concluded that the Commissioner's determination in these cases here was supported by the analyses set forth in *Johnson* v. *Commissioner*, 495 F.2d 1079 (6th Cir.), cert. denied, 419 U.S. 1040 (1974), and *Estate of Levine* v. *Commissioner*, 634 F.2d 12 (2d Cir. 1980). In *Johnson*, the taxpayer transferred stock with a basis of $10,000 and a fair market value of $500,000 to three separate trusts established for the benefit of his children. A few days prior to the transfer, however, the taxpayer had pledged the stock as collateral for a nonrecourse loan of $200,000. About a month after the transfer, the trustees cancelled the taxpayer's $200,000 note, substituting their own note for a like amount. When the transactions were completed, therefore, the taxpayer had $200,000 in cash and the trust had stock worth more than $500,000, encumbered by a $200,000 note. The taxpayer then used $150,000 of the loan proceeds to satisfy his gift tax liability arising from the transaction, and retained the $50,000 balance. The taxpayer conceded that he had realized $50,000 in income on the transaction, but he maintained that he did not realize any additional income when $150,000 of the loan proceeds were used to pay his gift tax liability.

On these facts, the court held that the taxpayer had received something of value upon transferring his en-

cumbered stock to the trust, and that the full amount of the loan assumed by the trustees constituted income to him in the year of receipt under Section 61 of the Code, as income from whatever source derived, and specifically under Section 1001 of the Code as gain from the disposition of property (495 F.2d at 1083-1084). The court noted that this would be the case whether the transfer were viewed as the discharge of the taxpayer's gift tax liability under *Old Colony Trust Co.*, or as the discharge of a debt under *Crane*. Under either analysis, the taxpayer is considered to have realized income (495 F.2d at 1084). As the court stated (*id.* at 1083): "The payment of a donor's gift tax liability by the donee constitutes income to the donor." In the court's view, it did not matter whether the gift taxes were paid through a loan placed on the property just prior to a gift of the encumbered property, or whether the gift taxes were paid directly by the donees as a condition to receiving the gift, as in the instant case. In both instances, the taxpayer raised the funds necessary to pay his gift tax liability out of the donated property itself, thereby obviating the necessity of using his personal funds for that purpose. Characterizing the transaction as a "net gift," as the taxpayer in *Johnson* urged, has no bearing on the income tax consequences arising on the transfer. As the court stated, "This suggestive but artificial language should not obscure the essence of the transaction in which the taxpayers engaged—the transfer of highly appreciated stock to a trust for their children's benefit, with the funds to pay their gift taxes raised out of the transferred property, plus additional cash" (*id.* at 1084).

Estate of Levine v. *Commissioner*, 634 F.2d 12 (2d Cir. 1980), is to the same effect. There, the taxpayer transferred property encumbered by a nonrecourse mortgage to a trust established for the benefit of his grandchildren. The trust accepted the property subject to the mortgage, and agreed further to pay certain expenses associated with the property for which the taxpayer was personally liable. At the time of the transfer,

the mortgage obligation plus the unpaid expenses exceeded the taxpayer's adjusted basis in the property. Following the principles established in *Crane* [13] and *Old Colony Trust Co.*, the court of appeals concluded that the taxpayer had realized taxable income to the extent the mortgage and expenses assumed by the trust exceeded his adjusted basis in the transferred property. Describing the transaction as other than a " 'pure' gift" (634 F.2d at 16), Judge Friendly pointed out in *Estate of Levine* that the taxpayer there had received valuable consideration for the gift, at least to the extent that his personal liability of $124,573.58 in unpaid expenses was discharged as a result of the transfer.[14] As the court viewed the matter, such a property transfer should be treated as though "the donee had paid * * * [that $124,573.58] sum directly to Levine [the donor-taxpayer]" (*ibid.*).

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[13] Contrary to the petitioners' (Br. 19-20) and the amicus Owen's arguments (Br. 18-19), the government has never conceded that the principles established in *Crane* were inapplicable to net gift transfers. In our brief on appeal in the court of appeals in *Johnson*, and in our Memorandum in Opposition filed in this Court (Oct. Term, 1974—No. 74-176), we noted the factual distinction in the cases between mortgaging property for the purpose of paying the gift taxes and then transferring the encumbered property, on the one hand, and making a gift of unencumbered property conditioned on the donee's payment of the gift tax liability, on the other. In the course of that discussion, we noted (Memorandum at 4) that in *Johnson* the taxpayer's "actual receipt of cash with no personal liability to repay it graphically illustrates the point" that his use of the cash from the loan proceeds to pay the gift tax liability was an "amount realized" under Section 1001(a). But as we further stated (*ibid.*), the distinction nevertheless "should not warrant a difference in tax treatment. In both cases, the amount of the gift tax is an 'amount realized' under Section 1001(a)."

[14] Under the rule of *Crane*, we submit that the transfer of property encumbered by any debt, recourse or nonrecourse, results in taxable income to the donor to the extent the liabilities discharged exceed the taxpayer's adjusted basis in the property transferred. See *Estate of Levine* v. *Commissioner*, *supra*, 72 T.C. at 792. But cf. *Tufts* v. *Commissioner*, 651 F.2d 1058 (5th Cir. 1981), rev'g 70 T.C. 756 (1978).

Both Dr. Johnson and Mr. Levine in the foregoing cases unquestionably received a measurable economic benefit upon their transfers of their appreciated property to the trusts. "Dr. Johnson received $200,000, free and clear of any obligation to repay that amount from any property in his possession. This amount constituted gross income in the year of receipt, under the broad definition set forth in section 61 of the Code—'all income from whatever source derived.' It makes no difference to what use the $200,000 was put, whether to pay for food or to pay a gift tax" (495 F.2d at 1083). Similarly, in *Levine*, "The donee assumed not only the $785,908.34 in mortgages and accrued interest for which Levine was not personally liable but also the $124,573.58 of 1969 expenses, not constituting a lien, for which he was" (634 F.2d at 16). As Judge Friendly there observed (*ibid.*), "If the donee had paid the latter sum directly to Levine, this case would clearly be governed by *Crane* since the donor would have received 'boot.' However, the assumption of another's legal obligation or debt is considered income under *Old Colony Trust Co.* * * *. We can thus see no sound reason for reaching a result differing from that in *Crane* on the facts of this case" (footnote omitted).

Since the donee's assumption of the donor's obligation is analytically equivalent to the donee's direct payment of cash in that amount to the donor, the reasoning of *Johnson* and *Estate of Levine* bears heavily on the transactions at issue here and effectively refutes petitioners' claim that a net gift yields no income tax consequences to the donor. For if the donees in the instant cases had paid the amount of the gift tax directly to petitioners, there would be no doubt that such amounts would have constituted gross income to petitioners in the year of receipt. Their payment of petitioners' gift tax obligations to the Internal Revenue Service is no less a measurable economic benefit that is includable in petitioners' gross income.

Johnson and *Estate of Levine* necessarily question the correctness of the two principal appellate authorities deal-

ing with net gifts upon which petitioners rely, *viz.*, *Turner* v. *Commissioner*, 49 T.C. 356 (1968), aff'd per curiam, 410 F.2d 752 (6th Cir. 1969), and *Hirst* v. *Commissioner*, 63 T.C. 307, aff'd 572 F.2d 427 (4th Cir. 1978). Those decisions, to which we now turn, are premised principally on the erroneous assumption that the donor's intent to make a net gift precludes imposition of tax on the gain arising from the transfer to the extent that the gift tax paid by the donee exceeds the donor's basis in the property. In our view, the donor's intention has no bearing upon the objective economic reality and the income tax consequences of these transactions.

C. The donor's intent to make a net gift does not preclude imposition of income tax on the gain arising from the transfer

1. Petitioners do not challenge the correctness of the foregoing analyses of *Johnson* v. *Commissioner*, 495 F.2d 1079 (6th Cir. 1974), and *Estate of Levine* v. *Commissioner*, 634 F.2d 12 (2d Cir. 1980). Rather, they argue (Br. 24-25) that those cases are distinguishable because "[a] net gift was not involved; a sale was involved" (Br. 24). Petitioners accordingly assert that they received no economic benefit upon their transfers because they simply intended to make a net gift and "[a] net gift is not a sale" (Br. 25).

But these *ipse dixits* that cast "sales" and "gifts" as two mutually exclusive categories that become applicable at the choice of the transferor are no more instructive than the "part sale and part gift" nomenclature that has been elsewhere employed to describe such transfers. See, *e.g.*, *Turner* v. *Commissioner*, *supra*. As the Sixth Circuit subsequently observed in *Johnson* v. *Commissioner*, *supra*, 495 F.2d at 1084, "This suggestive but artificial language should not obscure the essence of the transaction in which the taxpayers engaged—the transfer of highly appreciated stock to a trust for their children's benefit, with the funds to pay their gift taxes raised out of the transferred property, plus additional cash."

Moreover, characterizing the transaction as a "net gift" has no relevance to the income tax consequences of the transfer. As we have pointed out (*supra*, page 6, and note 8), the term "net gift" has meaning only for gift tax purposes. The donee's promise to pay the donor's tax necessarily reduces the value of the gift upon which the gift tax is imposed. Since the gift tax and the value of the gift are two dependent variables, the Service uses an algebraic formula to compute them. See Rev. Rul. 75-72, *supra*. But the formula "is concerned only with the gift tax consequences * * * [of a net gift transfer] and not with the income tax consequences thereof" (1975-1 Cum. Bull. at 313).

At all events, the fact that petitioners claim to have intended their transfers to be net gifts does not insulate them from income tax upon the gain arising from the transfers. As this Court pointed out in *Commissioner* v. *Duberstein*, 363 U.S. 278, 286 (1960), "the donor's characterization of his action is not determinative * * *. It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter." Hence, petitioners' subjective intent should not determine the income tax consequences of their actions in making a net gift. Given a choice, most taxpayers would claim to have intended to follow a course that would produce the least tax liability. Intent is therefore an unreliable indicium in such cases. Accordingly, if, as we submit, a net gift transfer confers a real and substantial benefit upon the donor in the form of the donee's discharge of the gift tax liability, that payment is an "amount realized" on the transfer that should result in taxable gain to the donor to the extent it exceeds his basis in the property, regardless of his intent. As the Sixth Circuit put the matter in *Johnson* v. *Commissioner*, *supra*, 495 F.2d at 1083 n.6: "[I]t is difficult to find that the parties here actually intended a part sale, part gift, in view of the obvious tax implications of such an intention. It is better to apply

the Tax Code equitably to basically similar transactions than to impose different results depending upon a hindsight determination of 'actual intent.' "

2. *Turner* v. *Commissioner*, 49 T.C. 356, aff'd per curiam, 410 F.2d 752 (6th Cir. 1969), and *Hirst* v. *Commissioner*, 572 F.2d 427 (4th Cir. 1978), upon which petitioners rely, are therefore erroneous because they principally turn on the donor's intention to make a net gift.[15]

a. In *Turner*, the taxpayer made nine separate transfers of low-basis securities to three individuals outright and to six others in trust. All of the transfers were conditioned on the payment by each transferee of the gift taxes imposed upon the taxpayer-donor. The funds used to pay the gift taxes were raised by a sale of some of the transferred stock, through family loans, by utilizing income earned from the trust, and by use of available cash. The Commissioner, in seeking to impose long-term capital gain upon the donor, argued that at least with respect to the individual donees, the transfers should be treated as part sales and part gifts, with the result that the taxpayer realized taxable gain on the transfers to the extent that the gift taxes paid by the donees on her behalf exceeded her adjusted basis in the stock transferred.

The Tax Court upheld the taxpayer's position that she had no taxable gain on the transfer. In so ruling, the court felt that the case turned on a choice between the net gift characterization urged by the taxpayer and the part gift, part sale nomenclature advanced by the Commissioner. Given the intra-family nature of the transfer, the Tax Court concluded that "what was intended by [the taxpayer] was a net gift, the value of the shares less the value of the gift tax payable on the transfers"

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[15] *Humacid Co.* v. *Commissioner*, 42 T.C. 894 (1964), upon which petitioners also rely (Br. 8), is distinguishable. There, the court held that a donor did not realize income when he made a gift of appreciated property. The case did not involve a gift of appreciated property made on the condition that the donee pay the resulting gift taxes.

(49 T.C. at 363). The court of appeals affirmed per curiam (410 F.2d 752 (6th Cir. 1969)).[16]

But, as we have pointed out (*supra*, pages 25-26), the income tax consequences of these transactions do not turn upon the subjective intent of the donor that he intended to make a gift, or a net gift, as opposed to a sale. The Service's published ruling (*supra*, page 6, note 8) makes clear that the term "net gift" is relevant only for purposes of computing the amount of gift tax due on such a transfer made on the condition that the donee pay the gift tax. For income tax purposes, however, the donee's discharge of the donor's gift tax obligation as a condition of the transfer is consideration that constitutes gross income under Section 61 and an "amount realized" under Section 1001(a) of the Code.[17] Thus, to the extent that the gift

[16] Petitioners (Br. 17, 29) and the amici (Owen Br. 4, 19, 22; Cleaver Br. 33, 41) claim that the Fifth Circuit would follow *Turner* in a net gift case. We submit, however, that the Fifth Circuit's position on this matter is not clear. Compare *Estate of Davis* v. *Commissioner*, 469 F.2d 694 (5th Cir. 1972), aff'g per curiam 30 T.C.M. (CCH) 1363 (1971), with *Malone* v. *United States*, 455 F.2d 502 (5th Cir. 1972), aff'g per curiam 326 F. Supp. 106 (N.D. Miss. 1971).

[17] The Tax Court in *Turner* appears to have been misled by the Commissioner's concession in that case that the transfers in trust (as opposed to those made directly to individuals) did not result in taxable gain to the donor. The Commissioner's concession was apparently prompted by the fact that the trustees were not personally liable for payment of the gift taxes imposed on the transfers (49 T.C. at 362-363). But this concession—which we believe to have been ill-advised and which was disavowed by the Commissioner in subsequent litigation—would have required the Tax Court to characterize similar transfers differently for tax purposes. It was not unreasonable for the court to have declined to do so. The court of appeals likewise attributed significance to the Commissioner's concession (410 F. 2d at 753). Subsequently, in *Johnson*, the Sixth Circuit characterized *Turner* as having "no precedential value beyond its peculiar fact situation" because of the Commissioner's concession in that case (see 495 F. 2d at 1086). The court below similarly confined *Turner* by citing the Sixth Circuit's subsequent characterization of it with approval (Pet. App. A7).

tax exceeds the donor's basis in the property, the donor must recognize gain.[18]

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[18] In rejecting the Commissioner's position in *Turner*, the Tax Court relied on a series of prior cases presenting the issue whether the donor had retained an income interest in trusts he established and which were funded by property transferred by him. In each of these "retained interest" cases (see Pet. App. A5-A6), the Commissioner, invoking the grantor trust provisions of Sections 671-677 of the Code, sought to tax the donor-settlor at ordinary income rates to the extent that trust income was used to satisfy the donor's gift tax liability. The Commissioner prevailed in several of the earlier cases (*e.g.*, *Estate of Staley* v. *Commissioner*, 47 B.T.A. 260 (1942), aff'd, 136 F.2d 368 (5th Cir. 1943); *Estate of Sheaffer* v. *Commissioner*, 37 T.C. 99 (1961), aff'd, 313 F.2d 738 (8th Cir. 1963), cert. denied, 375 U.S. 818 (1963) (*Sheaffer I*)), because the donor specifically conditioned the transfer of property to the trust he created upon the trust's use of trust income to pay his gift tax liability, either by payment to him directly (as in *Estate of Staley*), or by use of a loan which was required by the trust instrument and repaid from future trust income (as in *Sheaffer I*). Subsequent donors easily circumvented the grantor trust provisions, however, by structuring the transaction to give the trustee discretion to use any funds at its disposal for payment of the gift taxes. See, *e.g.*, *Estate of Morgan* v. *Commissioner*, 37 T.C. 981 (1962), aff'd, 316 F.2d 238 (6th Cir. 1963), cert. denied, 375 U.S. 825 (1963); *Estate of Sheaffer* v. *Commissioner*, 25 T.C.M. (CCH) 646 (1966) (*Sheaffer II*). For even if the gift taxes were, in fact, paid through a loan secured by the trust property, and future trust income was used to make the loan repayments (as in *Sheaffer I*), income could not be taxed to the donor under Section 677 if the trustee was given broad discretion to determine the method of paying the gift tax liability. *Estate of Morgan, supra; Sheaffer II, supra.* At all events, the donor's liability under Section 677 was limited to the income earned by the trust prior to the payment of the donor's gift tax liability. *Krause* v. *Commissioner*, 56 T.C. 1242 (1971).

In all of the retained interest cases, the decisions turned on the power granted to the trustee over the use of the trust income. If that power was too narrowly drawn, and trust income was paid to the donor or used to satisfy the donor's gift tax liability, the donor was subject to taxation as a beneficiary of the trust at ordinary income rates. But the instant cases do not involve taxation of trust income to petitioners under Section 677. Rather, the Commissioner seeks here to tax the gain represented by the dif-

Moreover, even on the assumption that the Tax Court in *Turner* correctly determined that the taxpayer there actually transferred only her net gift, as opposed to the entire property, she nevertheless should have been liable for the deficiency determined by the Commissioner. If the taxpayer in *Turner*, or, for that matter, petitioners here, are viewed as having satisfied their gift tax liability with a hypothetical "retained interest" [19] in the transferred property, the necessary consequence of such a theory is that they used appreciated property to satisfy their gift tax obligation.[20] In such circumstances, it is settled that the taxpayer must recognize gain to the extent the amount of the obligation discharged exceeded the taxpayer's adjusted basis in the "retained" property. *Danenberg* v. *Commissioner*, 73 T.C. 370, 380-381 (1979); *Bialock* v. *Commissioner*, 35 T.C. 649, 660 (1961); *Peninsula Properties Co.* v. *Commissioner*, 47 B.T.A. 84, 91 (1942). See

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ference between the gift tax paid and the donor's basis in the transferred property. Accordingly, the cases involving ordinary income taxation of trust income under Section 677 have no application here (see *Johnson* v. *Commissioner*, *supra*, 495 F.2d at 1085).

[19] Indeed, the retained interest approach proposed by petitioners arguably results in a greater deficiency than the Commissioner has determined. If the donor is deemed to have "retained" some of the property, it may be necessary to allocate petitioners' adjusted bases in the property proportionately between the retained interest and the portion transferred as a net gift. Such an allocation would increase their gain, because a lesser basis would be subtracted from the gift taxes paid in the determination of gain. Here, however, the Commissioner used petitioners' basis in the entire property as an offset against the gift tax to compute their taxable gain. The taxable gain determined by the Commissioner is correspondingly less than under petitioners' retained interest approach.

[20] While the retained interest approach may have relevance to transfers in trust where trust income is actually reserved for the benefit of the donor, it is inappropriate in circumstances where the gift tax liability may be satisfied from any assets of the donee. Even where the corpus of a trust may be used to satisfy this liability, Section 677 has no application because it only taxes trust income to the grantor.

also *United States* v. *Davis*, 370 U.S. 65 (1962) (husband's transfer of appreciated stock to wife in exchange for release of wife's marital claims is a taxable event).[21]

Nor does petitioners' attempted recharacterization of the transaction yield a different result. As they see the matter (Br. 6), "In the net gift, the donor places at the disposal of the donee properties sufficient to pay the gift taxes and secures from the donee an agreement to make the required payment. The donee is a conduit of the donor in making the tax payment and in doing so he is acting for the account of the donor." But the logical consequence of such an analysis would require attribution of the donee's gain on the sale of part of the property to pay the gift tax to the donor. This would be the case whether or not there is an actual sale of the property because the donor has transferred the property for the very purpose of paying the gift tax obligation. If, as petitioners concede, the donee is a "conduit" with respect to part of the property, his payment of the gift tax is equivalent to the donor's sale of that portion of property the sale of which would yield enough proceeds to meet the gift tax liability. See *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334 and n.4 (1945). In sum the net gift transaction cannot be recast in a manner that obscures the essential fact that the donor receives a real and substantial economic benefit from the donee's discharge of the gift tax obligation.[22]

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[21] In *Krause* v. *Commissioner*, *supra*, 56 T.C. at 1248, the Tax Court stated that if a donor had transferred cash in the amount of the gift tax instead of property, the use of the cash for the discharge of the gift tax liability would not have generated any taxable income. This is true enough (see Pet. Br. 26), but the donor's transfer of cash is tantamount to his paying the gift tax himself. Here, on the other hand, the donors transferred the property, and the donees promised to pay the gift tax from any source they deemed appropriate. The Tax Court's observation, as well as petitioners' various economic analyses (Br. 9-11), have no bearing on this case.

[22] In *Evangelista* v. *Commissioner*, 629 F.2d 1218, 1221 n.9 (7th Cir. 1980), aff'g 71 T.C. 1057 (1979), the court of appeals stated that under the Commissioner's net gift theory, a transfer conditioned on the donee's satisfaction of the donor's gift tax liability

The final ground upon which the Tax Court in *Turner* rested its decision is likewise unpersuasive. Contrary to the concerns expressed by the court in that case (49 T.C. at 363-364), and by the amicus Cleaver (Br. 21-22), the Commissioner's position requiring the donor to recognize gain does not result in an improper doubling of the basis computation for the property received by the donee. While the basis of the transferred property in the hands of the donee is not an issue presented for decision in these cases, § 1.1015-4 of the Treasury Regulations provides that the donee's basis is the greater of the amount paid by him for the property, or the donor's basis at the time of the transfer, and the amount of the gift tax paid (see App., *infra*, 9a). Here, the donee's basis is equal to the amount paid for the property (the discharge of the gift tax liability) plus the amount of the gift tax paid.

But there is actually no "double credit" involved. As the Sixth Circuit correctly explained in *Johnson* v. *Commissioner*, *supra*, 495 F.2d at 1085, the first upward adjustment in the donee's basis (for the amount paid) is necessary because the donor recognizes gain in that amount and that gain should not be taxed again.

> The * * * increase in the donee's basis which is attributable to gift taxes paid by the donor is independently proper. Its function, separate from that of the other * * * increase, is not to discourage gifts. Were basis not raised by the amount of gift taxes paid, a donor would recognize that a shift of resources to the donees would incur a tax without a corresponding adjustment in basis for the donees.

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would give rise to a tax *loss* if the gift taxes paid by the donee were less than the donor's basis in the property transferred. But while a loss might be realized in such an event, not every loss is deductible for income tax purposes. See, *e.g.*, Sections 267(a)(1) and 165(c) of the Code. See also § 1.1001-1(e)(1) of the Treasury Regulations on Income Tax (26 C.F.R.).

> Thus, Congress has authorized increases in a donee's basis both by amounts of gain recognized upon transfers to trusts and by amounts of gift taxes paid, regardless of the fact that such amounts may superficially appear redundant. See section 1015(b), (d); § 1.1015-2, -4, -5, Income Tax Regs.

Id. at 1085-1086; footnote omitted.

b. The en banc decision of the Fourth Circuit in *Hirst*, upon which petitioners rely (Br. 12-15, 27, 29), is likewise erroneous. In *Hirst*, the donor transferred three tracts of undeveloped land to her son and family. The transfers were conditioned on the donees' payment of the applicable federal and state gift taxes. The gift taxes paid by the donees ($85,469.55) exceeded the donor's $8,377 basis in the property transferred. The Commissioner thereafter determined that the $77,092.55 spread between those two amounts represented taxable gain to the donor (63 T.C. at 309-310). After reviewing the "tortuous course of decision" on the question, which it described as "characterized by subleties and fine distinctions" (*id.* at 310), the Tax Court ruled that its earlier decision in *Turner* was controlling.[23] Although the court

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[23] The Tax Court did not consider the Sixth Circuit's decision in *Johnson* as a "clear-cut overruling" of *Turner* (63 T.C. at 314-315). Pointing to the fact that the Commissioner's concession in *Turner* applied only to the transfers in trust, the Tax Court concluded that the court of appeals in *Johnson* "was mistaken in its assumption that the Commissioner's concessions in *Turner* deprived it of any precedential value beyond it own facts" (*id.* at 314). Although a panel of the Sixth Circuit in *Owen* v. *Commissioner*, 652 F.2d 1271, 1276 n.10, expressed apparent agreement with the Tax Court's conclusion as to the vitality of *Turner*, that panel decision was vacated by the court of appeals on September 11, 1981. Thus, the matter has hardly "been laid to rest," as petitioners claim (Br. 23). At all events, we submit that in determining the income tax consequences of net gifts, no distinction can be made between transfers to individuals and transfers in trust.

recognized that there was "much force" to the government's "more 'realistic' approach to the problem," it concluded that "in the absence of any clear-cut overruling of prior law by a Court of Appeals" that "[t]hings have gone too far by now to wipe the slate clean and start all over again" (*id.* at 315). In so holding, however, Judge Raum offered the following analysis that could be the basis of a decision upon such a clean slate (*ibid.*):

> The gift tax itself is imposed only upon the "net gift," *i.e.*, upon the gross amount of the property transferred minus the gift tax paid by the donee. In substance, a portion of the transferred property equal in value to the amount of the gift tax is not treated as having been part of the gift. But surely that portion did not vanish into thin air, and a strong argument can be advanced for the conclusion that it was exchanged for the donee's payment of the gift tax on the "net gift," a transaction that may result in the realization of gain or loss depending upon the donor's basis in the property. If the donor had sold that portion to an outsider immediately prior to the gift of the remainder, and then used the proceeds of the sale to pay the gift tax, the practical consequences to the donor would have been the same as in *Turner*, except that the donor would have been taxable on any gain realized on the sale.

In an en banc decision, the court of appeals affirmed. 572 F.2d 427 (4th Cir. 1978). Focusing on the taxpayer's alleged intent not to "sell" anything, the court held, in conformity with *Turner*, that the taxpayer had not realized taxable gain on the net gift transaction. The court noted that the taxpayer owed nothing prior to her decision to make the net gift and therefore concluded that "there was no economic gain of any kind accruing to her" and that she "received nothing" as a result of the transaction. *Id.* at 430-431. In the court's view

(*id.* at 431): "She was not better off after the transfer, with the donee undertaking the burden of the gift tax; she was simply not worse off."

Like the *Turner* decision which it follows, *Hirst* erroneously relies upon the donor's intent to make a gift, rather than a sale. But contrary to the court's conclusion, the taxpayer in *Hirst* was unquestionably "better off" as a result of the transaction. In parting with property with a low basis, she was relieved of her liability for payment of gift taxes in an amount substantially in excess of her basis. As the congressional reports pertaining to lifetime transfers state, the gift tax is "in reality * * * another 'cost' incurred in transferring the property from the donor to the donee, * * * which must be paid in order to make this transfer" (S. Rep. No. 1983, 85th Cong., 2d Sess. 70 (1958)). Since the donees in *Hirst* paid this "cost" on the taxpayer's behalf, the benefit to her was "as real and substantial" as if the donees had paid the applicable amount directly to the taxpayer. *Old Colony Trust Co.* v. *Commissioner, supra,* 279 U.S. at 729; *Crane* v. *Commissioner, supra,* 331 U.S. at 13.[24] An increase in net worth

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[24] *Crane* effectively refutes the amicus Owen's claim (Br. 19-21) that taxing the donor of a net gift exceeds the constitutional definition of income. The Court there explicitly held there is no constitutional prohibition against taxing the economic gain realized by the transferor of property upon the discharge of his indebtedness. As the Court stated (331 U.S. at 15; footnote omitted):

> Petitioner contends that the result we have reached taxes her on what is not income within the meaning of the Sixteenth Amendment. If this is because only the direct receipt of cash is thought to be income in the constitutional sense, her contention is wholly without merit. If it is because the entire transaction is thought to have been "by all dictates of common sense * * * a ruinous disaster," as it was termed in her brief, we disagree with her premise.

See *James* v. *United States,* 366 U.S. 213, 218-220 (1961); *Commissioner* v. *Glenshaw Glass Co.,* 348 U.S. 426, 431 (1955); *Mer-*

is not a *sine qua non* of taxable income. Rather, taxable income can arise as well when appreciated property is used to satisfy an obligation.[25]

Nor can the gift transfer be equated to a father's payment of an obligation of his son, as *Hirst* suggested (572 F.2d at 431). In such a case, the father made a gift to the son. But as we have pointed out (*supra*, page 17), there can be no suggestion under the facts of these cases that the donees of the property in question were making gifts to the donors in paying the latters' gift taxes. Cf. *Commissioner* v. *Duberstein*, *supra*. As the dissent in *Hirst* properly observed: "Taxpayer's

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chants' Loan & Trust Co. v. *Smietanka*, 255 U.S. 509, 519 (1921). Here, as in *Crane*, petitioners (Br. 4) have characterized their net gift transfers as resulting in an economic loss. But, as we have pointed out (*supra*, pp. 12-13, 19-24), the donees' satisfaction of petitioners' gift tax liability benefitted petitioners in exactly the same manner as if the donees had paid petitioners an equivalent amount in cash.

[25] See Note, *Federal Income Tax—Net Gift Doctrine—No Taxable Income Results from Gift Given Subject to Condition that Donee Pay Gift Tax (Hirst v. Commissioner, 572 F.2d 427 (4th Cir. 1978) (en banc))*, 63 Cornell L. Rev. 1074, 1082 (1978).

Other legal commentaries have similarly criticized the majority opinions in *Hirst*. *E.g.*, Note, *Taxation—Conditional Net Gift Transfers: No Income Tax Consequences to Donor—Hirst v. Commissioner, 572 F.2d 427 (4th Cir. 1978)*, 52 Temple L.Q. 139 (1979); Comment, *Federal Income Tax—Income Taxation of Net Gifts After Hirst v. Commissioner*, 32 Rutgers L. Rev. 389 (1979); Note, *Taxation—Net Gift Transfer of Appreciated Real Property Held Not to Give Rise to Taxable Gain for the Donor*, 57 N.C. L. Rev. 476 (1979); Note, *Income Taxation of Net Gifts—Hirst v. Commissioner*, 38 Md. L. Rev. 110 (1978); Note, *The Donor of a Gift Made Subject to the Condition that the Donee Pay State and Federal Gift Taxes on the Transfer Does Not Realize Taxable Income Even Though Gift Taxes Paid Exceed the Property's Adjusted Basis—Hirst v. Commissioner, 572 F.2d 427 (4th Cir. 1978) (en banc)*, 47 U. Cinn. L. Rev. 341 (1978).

argument that the payment of the taxes was a gift back to her is not supported by the facts stipulated by the parties and testified to by the son" (572 F.2d at 439 n.6).[26]

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[26] Petitioners and the amici further argue that the enactment in 1976 of Section 644 of the Code evidences Congress' implicit approval of the result reached in *Turner* and *Hirst*. Section 644 provides that if property transferred to a trust at less than its fair market value is sold by the trust less than two years later, the tax imposed on the sale is computed as though the transferor had made the sale. Section 644 thus erects a temporary barrier against a taxpayer's use of a trust to realize capital gains at a lower progressive rate structure.

But, contrary to petitioners' (Br. 34) and the amici's claims (Owen Br. 14-16; Cleaver Br. 23, 32-37), Section 644 has nothing to do with net gifts. Nowhere in the legislative history accompanying the passage of that provision is there any reference to the net gift cases such as *Turner* or *Johnson*. On the contrary, in enacting Section 644, Congress was not seeking either to codify or overrule the result reached in *Turner*. Rather, it was merely attempting to curb the "possible abuse where the grantor places in trust property which has unrealized appreciation in order to shift the payment of tax to the trust at its lower progressive rate structure." H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 186 (1976). The tax imposed under Section 644 applies whether or not gift taxes are imposed on the transfer, and if they are, who pays them; the statute also applies without regard to whether the transferor's basis in the property was greater or less than the gift taxes imposed on the transfer. In short, Section 644 is irrelevant to the determination whether a net gift transfer can result in taxable gain to the donor.

Finally, the amicus Owen argues (Br. 9, 15) that Section 644's temporary limitation of the bracket advantage for transfers in trust provides a remedy comparable to that sought by the government in the instant cases. This is incorrect. Imposing an income tax upon the donor of net gifts of highly appreciated property involves much more than the temporary elimination of the bracket advantage for transfers in trust. Rather, it determines the identity of the taxpayer who recognizes gain and it involves a significant timing aspect as well. If appreciated property is used to satisfy

D. A decision in favor of the Commissioner's position should be fully applicable to petitioners in these cases

Finally, petitioners (Br. 27-34) and the amici (Owen Br. 21-25; Cleaver Br. 37-43) claim that any decision by this Court in favor of the Commissioner should be prospective only, on grounds of *stare decisis* and their purported reliance on the Sixth Circuit's decision in *Turner*. As the court of appeals below correctly noted (Pet. App. A11), however, a taxpayer residing in one circuit may not avoid a tax otherwise due by claiming reliance upon a decision of another court of appeals. *Gulf Inland Corp* v. *United States*, 570 F.2d 1277, 1278 (5th Cir. 1978). Indeed, even reliance upon a decision of the court of appeals in the taxpayer's home circuit will not relieve him from taxation if the rule announced there is ultimately rejected by this Court. See *C. Blake McDowell, Inc.* v. *Commissioner*, 652 F.2d 606 (6th Cir. 1980), where the court of appeals held that a decision of this Court overruling existing case law in that circuit would be applied in all pending cases. Thus, in *United States* v. *Estate of Donnelly*, 397 U.S. 286 (1970), this Court's decision upholding the validity of a federal tax lien was applied even though the prevailing interpretation of the tax lien statute at issue in the taxpayer's home circuit would have invalidated the lien. Accord, *Hartman Tobacco Co.* v. *United States*, 471 F.2d 1327

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an obligation, there is a taxable event, and there is no reason to postpone the tax until a later date. Indeed, the property transferred may never be sold, thus postponing the tax indefinitely. Moreover, the tax abuse associated with net gift transfers and exemplified by the instant cases applies to outright transfers as well as to those in trust. As noted above, however, Section 644 has no application to outright transfers. Thus, it is altogether unreasonable to conclude that Congress, in enacting Section 644, intended to preclude income taxation of the gain the donor realizes in making net gift transfers.

(2d Cir. 1973); *Of Course, Inc.* v. *Commissioner*, 499 F.2d 754 (4th Cir. 1974); *Benedict Oil Co.* v. *United States*, 582 F.2d 544 (10th Cir. 1978).[27] See also *United States* v. *Darusmont*, 449 U.S. 292 (1981).

Thus, petitioners cannot escape taxation on the gain they realized from their net gift transfers by claiming that they relied on certain decisions holding that there was no taxable gain in those circumstances. This is especially true where, as here, the Commissioner has consistently taken the position that such transfers can result in taxable gain.[28] As this Court observed in *Estate of Donnelly*, *supra*, 397 U.S. at 294-295:

> Acts of Congress are generally to be applied uniformly throughout the country from the date of their

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[27] In *Benedict Oil Co.*, 582 F.2d at 549, the court quoted with approval the following language from one of its earlier opinions (*Sunray Oil Co.* v. *Commissioner*, 147 F.2d 962, 963-964 (10th Cir.), cert. denied, 325 U.S. 861 (1945) (footnotes omitted)):

> There is no vested right in the decisions of a court and a change of decision does not deprive one of equal protection of the laws or property without due process of law. It is a general rule that the decision of the highest appellate court of a jurisdiction overruling a former decision is retrospective in its operation. In effect, it declares that the former decision never was law.

[28] See, *e.g.*, Treasury Regulations § 1.1001-1(e), *supra* (originally promulgated as T.D. 6265, 1957-2 Cum. Bull. 463, 468, 22 Fed. Reg. 8935 (1957)); Rev. Rul. 70-626, 1970-2 Cum. Bull. 158; Rev. Rul. 71-232, 1971-1 Cum. Bull. 275, superseded by Rev. Rul. 75-72, 1975-1 Cum. Bull. 310. As the court noted in *Owen* v. *Commissioner*, *supra*, 652 F.2d at 1274: "[T]he Commissioner [has] never accepted the notion that a net gift results in no taxable income to the donor for income tax purposes."

Since the Commissioner's position regarding net gift transfers has been made clear in the pertinent Treasury Regulations for almost 25 years, a taxpayer cannot avoid the income tax consequences of his actions by looking for guidance only to the Regulations pertaining to the gift tax, as the amicus Cleaver argues (Br. 38-39).

> effectiveness onward. Generally the United States, like other parties, is entitled to adhere to what it believes to be the correct interpretation of a statute, and to reap the benefits of that adherence if it proves to be correct, except where bound to the contrary by a final judgment in a particular case. Deviant rulings by circuit courts of appeals, particularly in apparent dictum, cannot generally provide the "justified reliance" necessary to warrant withholding retroactive application of a decision construing a statute as Congress intended it.

In short, "Congress has indicated that, in federal tax law, claims of reliance are to be given little weight." *Gulf Inland Corp.* v. *United States*, *supra*, 570 F.2d at 1279. In making the net gift transfers at issue, petitioners simply ran the risk that the rule of law announced in *Turner* would not ultimately survive. *C. Blake McDowell, Inc.* v. *Commissioner*, *supra*, 652 F.2d at 607. See *United States* v. *Darusmont*, *supra* (upholding Congress' "retroactive" application of the 1976 amendments to the minimum tax). As this Court held in *Chevron Oil Co.* v. *Huson*, 404 U.S. 97 (1971), judicial decisions should be applied to all pending cases unless a "new principle of law" is established that would be aided by prospective application only, and nonretroactive treatment would avoid substantial inequitable results. Accord, *Wilson* v. *United States*, 588 F.2d 1168 (6th Cir. 1978). Taxing petitioners on the gain they realized upon their transfers of appreciated property does not produce "substantial inequitable results."

CONCLUSION

The judgment of the court of appeals should be affirmed.[29]

Respectfully submitted.

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[29] In both of these cases, the Commissioner took the position that the gain was taxable in the year the gift taxes were paid, rather than in the year the net gift transfer was made. In *Old Colony Trust Co., supra*, payment by a third party of a taxpayer's income tax liability was held to be the equivalent of the receipt of income by the person taxed, and thus constituted taxable income to the taxpayer in the year the tax was paid, despite the fact that the third party's agreement to pay the taxes was executed in a preceding year. 279 U.S. at 729. See *Hirst* v. *Commissioner*, *supra*, 572 F.2d at 439 (separate opinion of Judge Thomsen). As the court below noted (Pet. App. A2, n.2), petitioners have agreed that if taxable gain is realized as a result of their net gift transfers, the gain is properly taxable in the year the gift taxes were paid. There are, however, several net gift cases pending in the courts of appeals that present this timing question, arising from the fact that the gift taxes were paid in taxable years subsequent to the year of the gift. See, *e.g.*, *Davis* v. *Commissioner*, 74 T.C. 881 (1980), appeal pending, No. 81-1187 (6th Cir.); *Bradford* v. *Commissioner*, 70 T.C. 584 (1978), appeal pending, No. 79-1094 (6th Cir.); *Estate of Henry* v. *Commissioner*, 69 T.C. 665 (1978), appeal pending, No. 78-1340 (6th Cir.); *Estate of Currey* v. *Commissioner*, 41 T.C.M. (CCH) 800 (1981), appeal pending, No. 81-1423 (6th Cir.); *Estate of Weeden* v. *Commissioner*, 39 T.C.M. (CCH) 699 (1979), appeal pending, No. 80-7127 (9th Cir.); *Benson* v. *Commissioner*, 37 T.C.M. (CCH) 989 (1978), appeal pending, No. 79-1032 (6th Cir.). If, as we urge, the Court affirms the judgment below, it may wish to clarify the timing question in order to obviate the need for further litigation on this collateral issue.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C. (1970 ed.)*):

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property.

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

(b) *Cross References*—For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

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* Section 644 and Section 1015(d)(6) are codified in 26 U.S.C. (1976 ed. & Supp. III).

SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) *General Rule.*—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

* * * * *

SEC. 644 [as added by Section 701(e)(1), Pub. L. 94-455, 90 Stat. 1578, and amended by Section 701(p)(1-2), 92 Stat. 2908). SPECIAL RULE FOR GAIN ON PROPERTY TRANSFERRED TO TRUST AT LESS THAN FAIR MARKET VALUE.

(a) *Imposition of Tax.*—

(1) *In general.*—If—

(A) a trust (or another trust to which the property is distributed) sells or exchanges property at a gain not more than 2 years after the date of the initial transfer of the property in trust by the transferor, and

(B) the fair market value of such property at the time of the initial transfer in trust by the transferor exceeds the adjusted basis of such property immediately after such transfer,

there is hereby imposed a tax determined in accordance with paragraph (2) on the includible gain recognized on such sale or exchange.

(2) *Amount of tax.*—The amount of the tax imposed by paragraph (1) on any includible gain recognized on the sale or exchange of any property shall be equal to the sum of—

(A) the excess of—

(i) the tax which would have been imposed under this chapter for the tax-

able year of the transferor in which the sale or exchange of such property occurs had the amount of the includible gain recognized on such sale or exchange, reduced by any deductions properly allocable to such gain, been included in the gross income of the transferor for such taxable year, over

(ii) the tax actually imposed under this chapter for such taxable year on the transferor, plus

(B) if such sale or exchange occurs in a taxable year of the transferor which begins after the beginning of the taxable year of the trust in which such sale or exchange occurs, an amount equal to the amount determined under subparagraph (A) multiplied by the annual rate established under section 6621.

The determination of tax under clause (i) of subparagraph (A) shall be made by not taking into account any carryback, and by not taking into account any loss or deduction to the extent that such loss or deduction may be carried by the transferor to any other taxable year.

(3) *Taxable year for which tax imposed.*—The tax imposed by paragraph (1) shall be imposed for the taxable year of the trust which begins with or within the taxable year of the transferor in which the sale or exchange occurs.

(4) *Tax to be in addition to other taxes.*—The tax imposed by this subsection for any taxable year of trust shall be in addition to any other tax imposed by this chapter for such taxable year.

(b) *Definition of Includible Gain.*—For purposes of this section, the term "includible gain" means the lessor of—

(1) the gain recognized by the trust on the sale or exchange of any property, or

(2) the excess of the fair market value of such property at the time of the initial transfer in trust by the transferor over the adjusted basis of such property immediately after such transfer.

(c) *Character of Includible Gain.*—For purposes of subsection (a)—

(1) the character of the includible gain shall be determined as if the property had actually been sold or exchanged by the transferor, and any activities of the trust with respect to the sale or exchange of the property shall be deemed to be activities of the transferor, and

(2) the portion of the includible gain subject to the provisions of section 1245 and section 1250 shall be determined in accordance with regulations prescribed by the Secretary.

* * * * *

SEC. 671. TRUST INCOME, DEDUCTIONS, AND CREDITS ATTRIBUTABLE TO GRANTORS AND OTHERS AS SUBSTANTIAL OWNERS.

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable in-

come and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange of property, the extent to which the gain or loss determined under this section shall be recognized for purposes of this subtitle shall be determined under section 1002.

* * * * *

SEC. 1015. BASIS OF PROPERTY ACQUIRED BY GIFTS AND TRANSFERS IN TRUST.

(a) *Gifts After December 31, 1920.*—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in section 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value. If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Secretary or his delegate shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary or his delegate finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary or his delegate as of the date or approximate date at which, according to the best information that the Secretary or his delegate is able to obtain, such property was acquired by such donor or last preceding owner.

* * * * *

(d) [as added by Section 43(a), Pub. L. 85-866, 72 Stat. 1640] *Increased Basis for Gift Tax Paid.*—

(1) *In general.*—If—

(A) the property is acquired by gift on or after the date of the enactment of the Technical Amendments Act of 1958, the basis shall be the basis determined under subsection (a), increased (but not above the

fair market value of the property at the time of the gift) by the amount of gift tax paid with respect to such gift, or

(B) the property was acquired by gift before the date of the enactment of the Technical Amendments Act of 1958 and has not been sold, exchanged, or otherwise disposed of before such date, the basis of the property shall be increased on such date by the amount of gift tax paid with respect to such gift, but such increase shall not exceed an amount equal to the amount by which the fair market value of the property at the time of the gift exceeded the basis of the property in the hands of the donor at the time of the gift.

* * * * *

(6) [as added by Section 2005(c), Pub. L. 94-455, 90 Stat. 1877] *Special rule for gifts made after December 31, 1976.*—

(A) *In general.*—In the case of any gift made after December 31, 1976, the increase in basis provided by this subsection with respect to any gift for the gift tax paid under chapter 12 shall be an amount (not in excess of the amount of tax so paid) which bears the same ratio to the amount of tax so paid as—

(i) the net appreciation in value of the gift, bears to

(ii) the amount of the gift.

(B) *Net appreciation.*—For purposes of paragraph (1), the net appreciation in value of any gift is the amount by which the fair market value of the gift exceeds the donor's adjusted basis immediately before the gift.

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§ 2501 [as amended by Section 109(a), Pub. L. 89-809, 80 Stat. 1574, and Section 102(a)(1), Pub. L. 91-614, 84 Stat. 1838]. Imposition of tax.

(a) *Taxable transfers.*

(1) *General rule.*

For the first calendar quarter of calendar year 1971 and each calendar quarter thereafter a tax, computed as provided in section 2502, is hereby imposed on the transfer of property by gift during such calendar quarter by any individual resident or nonresident.

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§ 2502. Rate of tax.

(a) [as amended by Section 102(a)(2), Pub. L. 61-614, 84 Stat. 1839] *Computation of tax.*

The tax imposed by section 2501 for each calendar quarter shall be an amount equal to the excess of—

(1) a tax, computed in accordance with the rate schedule set forth in this subsection, on the aggregate sum of the taxable gifts for such calendar quarter and for each of the preceding calendar years and calendar quarters, over

(2) a tax, computed in accordance with such rate schedule, on the aggregate sum of the taxable gifts for each of the preceding calendar years and calendar quarters.

* * * * *

(d) *Tax to Be Paid by Donor.*—The tax imposed by section 2501 shall be paid by the donor.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.1001-1(e)

(e) *Transfers in part a sale and in part a gift.* (1) Where a transfer of property is in

part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis. For the determination of basis of property in the hands of the transferee, see § 1.1015-4. For the allocation of the adjusted basis of property in the case of a bargain sale to a charitable organization, see § 1.1011-2.

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§ 1015-4. *Transfers in part a gift and in part a sale.*

(a) *General rule.* Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of—

(1) Whichever of the following is the greater:

(i) The amount paid by the transferee for the property, or

(ii) The transferor's adjusted basis for the property at the time of the transfer, and

(2) These amount of increase, if any, in basis authorized by section 1015(d) for gift tax paid (see § 1.1015-5).

For determining loss, the unadjusted basis of the property in the hands of the transferee shall not be greater than the fair market value of the property at the time of such transfer. For determination of gain or loss of the transferor, see § 1.1001-1(e) and § 1.1011-2. For special rule where there has been a charitable contribution of less than a taxpayer's entire interest in property, see section 170(e)(2) and § 1.170A-4(c).

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